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Realignment of Parties in Stockholder's Derivative Suits Where Jurisdiction Is Based upon Diversity of Citizenship

Garry A. Pearson

REALIGNMENT OF PARTIES IN STOCKHOLDER'S DERIVATIVE SUITS WHERE JURISDICTION IS BASED UPON DIVERSITY OF CITIZENSHIP

The Federal Rules of Civil Procedure permit an aggrieved stockholder to sue his corporation and one he alleges to be liable to that corporation in a single suit in Equity, thereby asserting rights that are derived from those of the corporation.[1] The corporation, in this action is an essential, not a nominal party.[2] When the basis for jurisdiction in the federal courts is diversity of citizenship the question arises: what is the proper location of the corporation in regard to being a party plaintiff or defendant? This is crucial, for the courts since the case of *Strawbridge v. Curtis*[3] have required that all plaintiffs must be diverse as to all defendants. Many cases arise where the citizenship of the corporation will be the same as that of the other defendants, and the plaintiff-stockholder will be diverse as to both; or the citizenship of the stockholder and that of the corporation will be identical, while the third party will have a different situs of citizenship. In the former situation, the case is cognizable in a court of Equity in the federal system, while in the latter it will not be removable by the defendant to a federal court, provided the court does not realign the corporation as a party plaintiff.

What then determines the proper location of the corporation in a stockholder's derivative suit where the sole basis for federal jurisdiction is diversity of citizenship? The court will not take cognizance of the alignment made by the parties where it appears that the suit is one that is collusively made with the purpose of manufacturing federal court jurisdiction.[4] Thus, if the court finds that the corporation and the stockholder are joined in their desire to prosecute the action, the court will realign the corporation as a party plaintiff.[5] In that case if diversity of citizenship is the sole basis for jurisdiction, the court must dismiss upon the rule in *Strawbridge v. Curtis.*[6]

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1. Fed. R. Civ. P. 23 (b).
2. Meyer v. Fleming, 327 U.S. 161 (1946); Davenport v. Dows, 85 U.S. (18 Wall.) 626 (1873); Groel v. United Elec. Co., 132 Fed. 252 (C.C.N.J. 1904).
3. 7 U.S. (3 Cranch) 267 (1806).
4. 28 U.S.C. § 1359 states: "A district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court."
5. See Helm v. Zaracor, 222 U.S. 32, 36 (1911). The Supreme Court said in this instance: "It was, undoubtedly, the duty of the Court in determining whether there was the requisite diversity of citizenship to arrange the parties with respect to the actual controversy, looking beyond the formal arrangement made by the bill."
6. 7 U.S. (3 Cranch) 267 (1806).

But what constitutes collusion that will destroy the alignment made by the parties to the action? The Federal Rules of Civil Procedure, as did Equity Rule 94 under the older rules of practice,[7] require an allegation under oath that the action is not collusive in order to confer jurisdiction.[8] In addition, the federal courts are forbidden from taking cognizance of a civil action in which a party has been collusively made or joined to invoke the jurisdiction of that court,[9] and such a defect may be considered at any time in the course of the trial.[10] Collusion essentially becomes an element of fact that a party may present to the court or the court may take up on its own motion,[11] and if the elements of collusion are found, the court will be without jurisdiction to consider the action.

The requirements have supposedly been more strict, however, than mere realignment upon the basis of known collusion. In an effort to restrict federal diversity jurisdiction, the courts have required that there be an "actual",[12] "substantial",[13] controversy between each plaintiff and each defendant. It may easily be seen that while the stockholder is suing for the enforcement of his rights, the result of a successful lawsuit will accrue directly to the benefit of the corporation, and only incidentally to the stockholder. Accordingly, the rule has been developed that the actual and substantial controversy between the stockholder and corporation must be one "in which the corporation is disabled from protecting itself",[14] or the management of that corporation assumes a "hostile attitude"[15] towards the stockholder. The exact import of these terms had not become apparent until the Supreme Court was presented with the question of whether an honest difference of opinion will suffice to create a substantial and actual controversy between these parties.

This problem was raised recently in two decisions of the Supreme Court: *Smith v. Sperling*[16] and *Swanson v. Traer*[17] were

7. Equity Rule 94, Promulgated January 23, 1882, 104 U.S. IX, later Equity Rule 27.
8. Fed. R. Civ. P. 23 (b). ". . . the complaint shall be verified by oath and shall aver . . . (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction."
9. 28 U.S.C. § 1359.
10. Quincy v. Steel, 120 U.S. 241 (1887).
11. Mansfield, Coldwater & Lake Michigan Ry. v. Swan, 111 U.S. 379 (1884). The federal courts also have power to search the entire record to attack jurisdiction; Sun Printing & Publishing Ass'n. v. Edwards, 194 U.S. 377 (1904).
12. See Helm v. Zaricor, 222 U.S. 32 (1911).
13. See Niles Bemont-Pond Co. v. Iron Moulder's Union, 254 U.S. 77 (1920).
14. Koster v. Lumberman's Mut. Cas. Co., 330 U.S. 518, 523 (1947).
15. Cutting v. Woodward, 255 Fed. 633, 635 (9th Cir. 1918).
16. 77 S. Ct. 1112 (1957).
17. 77 S. Ct. 1116 (1957).

considered together by the Court. In the former, plaintiff, a citizen of New York, brought an action as a stockholder of Warner Bros. Pictures Inc., a Delaware citizen for purposes of determining diversity jurisdiction,[18] against Warner Bros. and United States Pictures Inc., another Delaware corporation. Plaintiff alleged that one Harry Warner and his brothers controlled said Warner Bros. corporation, and that they caused that company to enter into an agreement with United States Pictures, a corporation solely owned by Sperling, for the production of motion pictures that was "upon terms improvident and unfair as to Warner Bros., and unwarrantedly favorable to United."[19] The district court held a preliminary trial to determine the motive of the defendants Warners, and found that they were in no way in control of the corporation, and had at all times acted in good faith "for the best present and future financial interests of the corporation . . . ." The court accordingly realigned the defendant Warner Bros. with the plaintiff, and dismissed the cause of action for want of jurisdiction.[20]

The latter case involved certain citizens of Nevada as plaintiffs, against their corporation, the Chicago North Shore and Milwaukee Railway Company, an Illinois citizen, and certain other Illinois citizens, who were formally directors of the defendant railroad. Plaintiff requested the corporation to sue these directors upon a supposed breach of their fiduciary duties, but the present management, upon advice of counsel, refused. After plaintiff brought this action, the corporation appeared and supported the case of the other defendants. The corporation expressed the view they wished as quick and speedy a determination of the trial as possible, and doubted any possibility of recovery by the plaintiff. Aside from that statement, the corporation remained neutral. The district court held that the railway company must be realigned as a party plaintiff, destroying diversity jurisdiction.[21]

The Supreme Court upheld federal diversity jurisdiction in both these cases. In their opinion, fraud on the part of the management of the corporation was not necessary to show an actual controversy between the corporation and the stockholder.[22] Antagonism, used

18. Marshall v. Baltimore & Ohio R.R., 57 U.S. (1 How.) 314 (1854). For diversity of citizenship purposes, a corporation is treated as a citizen of the state of incorporation by a conclusive presumption that the suit is really one against the stockholder and that the stockholders are all citizens of the state of incorporation.

19. 117 F. Supp. 781, 786 (S.D. Cal. 1953).

20. 117 F. Supp. 781 (S.D. Cal. 1953), *aff'd.* 237 F.2d 317 (9th Cir. 1956), *cert. granted,* 352 U.S. 865 (1956).

21. 230 F.2d 228 (7th Cir. 1956), *cert. granted,* 352 U.S. 865 (1956).

22. 77 S. Ct. 1112 (1957).

in many previous decisions upholding diversity jurisdiction in stockholder's suits, does not necessarily connote wrongdoing, but may result from an honest difference of opinion, where the corporation defends a course of conduct that the stockholder opposes.[23] The capacity to maintain a stockholder's suit of this nature depends upon local law since the decision in *Erie v. Tompkins;*[24] questions of the jurisdiction of the federal courts rests upon federal law. If the Court adopts the procedure of the lower court in *Smith v. Sperling,* there would have to be two trials of the basic issue of wrongdoing, one upon local and one upon federal law.[25] On this aspect, the Court said: "To stop and try the charge of wrongdoing is to delve into the merits. . . . It is a time consuming, wasteful exertion of energy upon a preliminary issue in the case."[26] They further pointed out that collusion can always be shown, at any time in the trial, and said "absent collusion there is diversity jurisdiction when the real collusion of issues . . . is between citizens of different states."[27] An honest difference of opinion is such a collusion.

Mr. Justice Frankfurter, joined by Justices Burton, Harlan, and Whittaker, dissented in an opinion based upon their belief that the majority had "overturned a half-century's precedents"[28] in arriving at their decision, thus making the "exception the rule".[29] They charged that the majority had misconstrued precedent in determining that antagonistic control includes an honest difference of opinion; that jurisdiction in such a stockholder's suit is reserved to that class of cases where the corporation, because of fraud on the part of its management, is incapacitated from acting for itself, and the stockholder is allowed to sue somewhat as a "next friend"[30] The dissenters indicated that there was constitutional objection, saying that it would be an ". . . unconstitutional invasion of the jurisdiction of the state courts—for a federal court to sustain federal jurisdiction of a civil action between private persons . . . when diversity of citizenship as to the 'matter in controversy' does not exist."[31]

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23. *Ibid.*
24. 304 U.S. 64 (1938); Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1948).
25. 117 F.Supp. 781 (S.D. Cal. 1953).
26. 77 S. Ct. 1112, 1115 (1957).
27. *Id.* at 1116.
28. 77 S. Ct. 1119 (1957).
29. *Ibid.*
30. Koster v. Lumberman's Mut. Cas. Co., 330 U.S. 518, 523 (1947).
31. See note 28 *supra* at 1126.

Since the majority and the minority opinions cited the same cases in support of their views, it is necessary to consider a few of these cases to develop a sound concept of the basis of this type of jurisdiction. The first important decision in this field arose before the courts were given power to look behind the pleadings to determine the proper alignment of the parties,[32] but it is good law on the basis of the right to sue where the corporation is deemed to be in antagonistic hands.[33] Stemming from that doctrine, but with the added power to look beyond the arrangement of the parties, the cases decided by the Supreme Court have generally broken down into two classifications: (1) those where jurisdiction was upheld on the basis of an alleged fraudulent action by the management of the corporation, evincing an attack not only upon the third party but also upon the management, and (2) the cases where jurisdiction has been found lacking because of collusion between the stockholder and the management of the corporation, or for failure to allege absence of collusion in complying with pleading rules.

Illustrative of the former line of cases is the oft-quoted decision of *Doctor v. Harrington*.[34] There the Supreme Court upheld diversity jurisdiction where it appeared that a majority stockholder had delivered to another corporation a promissory note for no consideration, and later levied upon the capital stock of the new corporation in the hands of the plaintiff's corporation to satisfy the note. Regarding the problem of antagonistic control, the Court said: "The ultimate interest of the corporation made defendant may be the same as that of the stockholder made plaintiff, but the corporation may be under a control antagonistic to him, and made to act in a way detrimental to his rights. In other words, his interests, and the interest of the corporation, may be made subservient to some illegal purpose. If a controversy hence arise, and the other conditions of jurisdiction exist, it can be litigated in a federal court."[35]

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32. 18 Stat. 470 (1875), 28 U.S.C. § 1359 (1948).

33. Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855).

34. 196 U.S. 579 (1905); See also Koster v. Lumberman's Mut. Cas. Corp., 330 U.S. 518 (1947); Meyer v. Fleming, 327 U.S. 161 (1945); Hill v. Wallace, 259 U.S. 44 (1922); Delaware & Hudson Co. v. Albany & S. R.R., 213 U.S. 435 (1909); Schimdt v. Esquire, Inc., 210 F.2d 908 (7th Cir. 1954); Lavin v. Lavin, 182 F.2d 870 (2d Cir. 1950); Gratz v. Murchison, 130 F. Supp. 709 (D. Del. 1955); Ashley v. Keith Oil Co., 73 F. Supp. 37 (D. Mass. 1947); J.R.A. Corp. v. Boylan, 30 F. Supp. 393 (S.D.N.Y. 1939); Nagle v. Wyoga Gas & Oil Corp., 10 F. Supp. 905 (M.D. Pa. 1935); Harris v. Brown, 6 F.2d 922 (W.D. Ky. 1925); Groel v. United Electric Co., 132 Fed. 252 (C.C.N.J. 1904).

35. Doctor v. Harrington, 196 U.S. 579, 587 (1904).

Again, in *Venner v. Great Northern Railway Co.*,[36] the Court was faced with an allegation in the complaint that the president, James J. Hill, had made a secret profit at the expense of the stockholders of the railroad. The court below found that the plaintiff had not complied with Equity Rule 94, and for that reason the court was without jurisdiction. The Supreme Court reversed, finding that the proper jurisdictional elements were present, and that failure to comply with a rule of pleading such as Rule 94 was not jurisdictional, but went to the merits.

The second group of cases, where jurisdiction is denied because of collusion between the corporation and the stockholder is typified by *Niles Bemont-Pond Company v. Iron Moulders Union Local #68.*[37] A stockholder sued his corporation and a local labor union, praying for an injunction to prevent the union from molesting workers who attempted to cross picket lines. The Court found collusion in the fact that the plaintiff was the majority stockholder of the defendant corporation and could easily have brought the action directly through the corporation. In a similar case,[38] the suit was dismissed for lack of jurisdiction over a collusive action where it was found by the court that the plaintiff had maneuvered his request upon the board of directors to comply with Equity Rule 94, solely to maintain an action in the federal courts. The Court here said: ". . . he [the stockholder] must show a clear breach of duty on their [directors, management] part in neglecting or refusing to act in the matter, amounting to such grossly culpable conduct as would lead to irremediable loss to to him if he were not permitted to bring the matter before the courts. And such neglect and refusal must not be simulated, but real and persisted in, after earnest efforts to overcome it."[39]

Hawes v. City of Oakland[40] is a leading case on this subject and was cited by both the majority and minority opinions in the *Swanson* and *Sperling* cases, the majority distinguishing it, and the minority relying upon it. The Court there found circumstances indicating that the sole remedy was directed towards the City of

36. 209 U.S. 24 (1908).

37. 254 U.S. 77 (1920). See also Chase National Bank of City of New York v. Indianapolis, 314 U.S. 63 (1941); Hamer v. N.Y. Rys., 244 U.S. 266 (1917); Dawson v. Colombia Ave. Trust Co., 197 U.S. 178 (1905); Ill. Cent. R. Co. v. Adams, 180 U.S. 28 (1901).

38. Detroit v. Dean, 106 U.S. 537 (1882).

39. *Id.* at 542.

40. 104 U.S. 450 (1881) "The court laid down the requirements a stockholder must meet to bring the action in his own name in a derivative suit. These requirements differ from the requirements of jurisdiction, as carefully explained in Venner v. Great No. Ry., 209 U.S. 24 (1908). Failing to comply with the Federal Rule of Civil Procedure 223 (b), which is based on Hawes v. Oakland, goes to the merits, not to jurisdiction.

Oakland, and not towards the corporation. No allegation of fraud was present, only a refusal to sue on the part of the board of directors, but there were hints of collusion which the court alluded to, and they dismissed the action for want of equity, not jurisdiction. However, to distinguish from the *Swanson* and *Sperling* cases, it must be mentioned that the Court cited with approval the English doctrine of *MacDougall v. Gardiner*,[41] and quoted from that case saying: " . . . nothing connected with internal disputes between shareholders is to be made the subject of a bill by some one shareholder on behalf of himself and others, unless there be something illegal, oppressive, or fraudulent . . . ." The Court also quoted with approval *Dodge v. Woolsey*.[42]

Thus it will be seen that numerous statements occur throughout the cases to the effect that bad faith is a necessary element in a stockholder's derivative suit; where jurisdiction was upheld bad faith was present but where jurisdiction was denied, bad faith was not determinative, as collusion or something very near to it existed, which would deny the power of the court to hear the case in any event.

Very few cases on alignment of parties for diversity purposes in derivative suits have appeared between the two named classifications; fraud or bad faith on one hand, and collusion on the other. By the way of a dicta in the case of *Schmidt v. Esquire, Inc.*,[43] a lower court held that a refusal on the part of the management to sue need not stem from improper motives. In *Groel v. United Electric Company*[44] the test was laid down that such a suit as here contemplated would be allowed ". . . whenever the officers or persons controlling the corporation are shown to be opposed to the object sought by the complaining stockholder . . ." But in the latter case there was an allegation of bad faith on the part of management of the corporation, and jurisdiction would have been upheld in absence of the word *opposition* even if construed to include a good faith difference of opinion. The Supreme Court of the United States decided a case that fit into this category upon its facts, in *Hill v. Wallace*.[45] A stockholder had requested his board of directors to bring suit to test the validity of a statute, and they had refused. Chief Justice Taft stated that the refusal in this case was not an error in judgment in view of the fact that

41. 1 Ch. D. 13 (1875).
42. See note 33 *supra*.
43. 210 F.2d 908, 912 (7th Cir. 1954).
44. 132 Fed. 252, 264 (C.C.N.J. 1904).
45. 259 U.S. 44 (1922).

the law so seriously affected the value of the stock held by the stockholders that such refusal was a breach of duty, though not involving "moral delinquency."[46] Thus, it would seem that the case merely followed the prior cases in their test of bad faith, and indeed, the Court cited *Dodge v. Woolsey* as controlling. On the other hand, the Court, in *Chicago v. Mills*,[47] found that there was a mere "difference of opinion" between one stockholder and the board of directors as to the advisability of bringing suit, but there was nevertheless collusion between the corporation and the stockholder on an understanding of all facts leading up to suit. Thus it may be seen that no case has come into the federal courts quite on "all fours" with the cases of *Smith v. Sperling* and *Swanson v. Traer*, though the courts have completely surrounded the problem with dicta.

There are a number of considerations that would strongly affect the attitude of a practicing attorney. In the view taken by the district court in *Smith v. Sperling* a separate trial would be necessary whenever a plaintiff alleged bad faith on the part of the management, and this trial would have to be decided on federal law as being a matter of procedure, not substance.[48] This trial would very likely duplicate the matters to be considered on a trial of the substantive elements of the controversy, decided on local law. The trial in the *Sperling* case lasted fifteen days, and revealed only that under federal law the defendant had acted in the utmost good faith.[49] Therefore, the plaintiff is thrown out of the federal courts on a matter preliminary to the basic problem only to continue his litigation in the state court if he persists.[50] The *Sperling* case had been in the federal system for eight years,[51] and to dismiss for want of jurisdiction would indicate a wasteful use of the time and energy of the federal courts. Moreover, by tying the issue of jurisdiction to bad faith alone, an element of uncertainty

46. *Id.* at 61.
47. 204 U.S. 321, 328 (1907).
48. 117 F. Supp. 781 (1953) The district court decided that the question whether a corporation was in antagonistic hands was a question of fact, citing KVOS, Inc. v. Associated Press, 299 U.S. 269 (1936), and a trial should be necessary to determine this issue. This statement has been attacked, as in Gratz v. Murchison, 130 F. Supp. 709 (D. Del. 1955) "Moreover, I find no case other than Smith v. Sperling holding realignment of the corporation calls for a factual determination for jurisdictional purposes. An allegation in a complaint the wrongdoer controls the corporation, I think, is determinative for jurisdictional purposes since, in determining whether a cause of action is removable, we look to the plaintiff's pleadings which controls." See also 3 Moore Federal Practice, ¶ 19.13 (Supp. 1955).
49. 117 F. Supp. 781, 804 (S.D. Cal. 1953).
50. So. Pac. Co. v. Bogart, 250 U.S. 483 (1919) A dismissal for want of jurisdiction is not res adjudicata on the merits.
51. See note 16 *supra* at 1115.

will obviously arise, in an area already confusing, and another requirement of jurisdiction would exist where none is required by the Constitution.[52]

Conversely, cases in which the corporation is made plaintiff would allow the suit to reach the federal courts where the citizenship of the stockholder and the corporation is identical, and that of the other defendants foreign, thus increasing jurisdiction in that class of cases, though it is usually no problem to find an out of state stockholder to institute suit.[53]

The overall effect of the doctrine set forth in the *Sperling* and *Swanson* cases in the lower courts would be to decrease the amount of cases handled by the federal courts,[54] and this is consonant with a tendency to limit rather than to expand federal jurisdiction.[55] It would also be a method of aiding the courts in determining collusion, e.g., to say that there is collusion of interests whenever there exists only an honest difference of opinion between th stockholder and his corporation. But in an effort to limit jurisdiction, the rule of the lower courts would result in denying a stockholder the use of the federal courts where the citizenship of the corporation and the other defendants is the same, and a disloyal management hides behind an assumed attitude of strict neutrality to the suit.

The dissent in the *Sperling* and *Swanson* cases, suggested by the district court in the *Sperling* case, indicated a constitutional objection to the exercise of federal jurisdiction, claiming that there was not a "case or controversy" as required by article III.[56] Of course, practical considerations would not justify the use of the federal courts where jurisdiction on the basis of diversity of citizenship does not exist, but that objection merely contemplates that there will be no controversy between two indispensable parties, the stockholder and the corporation. Should there be actual collusion, it can be shown at any time during trial, and will go to defeat jurisdiction at that point.[57] Absent collusion, there is an actual controversy between citizens of different states, and it would appear

52. U.S. Const. art III § 2. As to whether there is a valid controversy, see J.R.A. Corp. v. Boylan, 30 F. Supp. 393, 394 (S.D.N.Y. 1939): "[W]hen the corporation is antagonistic to the aims of the plaintiff stockholder, and refuses to enforce its rights, . . . this refusal is it itself, a controversy to which the corporation is a real party defendant."

53. Hawes v. Oakland, 104 U.S. 450 (1881); Lavin v. Lavin, 182 F.2d 870 (2d Cir. 1950).

54. 54 Colum. L. Rev. 629 (1954).

55. Wechlser, Federal Jurisdiction and the Revision of the Judicial Code, 13 Law & Contemp. Prob. 216 (1948).

56. See note 28 *supra* at 1126.

57. 28 U.S.C. § 1359.

that this should stand regardless of whether the stockholder prays for relief against the corporation or not. The only true objection to diversity jurisdiction in stockholder's suits should be where the element of collusion is present. Furthermore jurisdiction should be determined from the pleadings not on the basis of conjectural bad faith which only a trial on that issue could prove; an allegation that the corporation has refused to sue to uphold rights the stockholder wishes to enforce should be sufficient to establish jurisdiction in the federal courts.

The rule unquestionably today is that a refusal by a corporation's management based upon an honest difference of opinion is sufficient to prevent realignment in stockholder's derivative suits based upon diversity of citizenship, and is likewise sufficient to comply with Federal Rule of Civil Procedure 23 (b). To achieve this result, the Supreme Court refused to recognize the test laid down in dicta in numerous cases decided in the past century, because that dicta could not be tailored to achieve a just and practical result in an area where it was needed. No invasion of the doctrine of stare decisis has taken place; rather, the Court has reached a sensible result not contemplated by prior decisions.

GARRY A. PEARSON

WHAT CONSTITUTES THE PRACTICE OF MEDICINE IN NORTH DAKOTA

Not too many centuries ago it was generally believed that evil spirits were responsible for the illnesses that plague mankind. Though the modern patient does not entertain that absurdity, his state of enlightenment regarding the nature of the ailments that beset him is but little advanced beyond that of his Stone Age counterpart. Happily, however, the modern patient enjoys the benefits of a vast fund of medical knowledge and a set of laws assuring him, to a considerable degree, that those in whom he entrusts his health and life are possessed of that knowledge. It is with these laws, the laws regulating the practice of medicine, that this paper is concerned.[1]

1. General references include: Lott and Gray, Law in Medical and Dental Practice (1942); Bangs, *Christian Science Practice — Legality*, 25 J. Crim. L. 271 (1934); Caldwell, *Early Legislation Regulating the Practice of Medicine*, 18 Ill. L. Rev. 225 (1923); Field, *Nature of the A.M.A. Fight Against Quackery in Medicine*, 9 Food, Drug, Cosmetic L. J. 213 (1954); Grills, *Regulation of the Practice of Medicine in the State of Michigan*, 15 U. Detroit L. J. 42 (1952); Heilman, *Medical Charlatanism, Legal Control of*, 22 N. C. L. Rev. 23 (1943); Sears, *Legal Control of Medical Practice; Validity and Methods*, 44 Mich. L. Rev. 689 (1946).